

U.S. BANKRUPTCY COURT  
NORTHERN DISTRICT OF TEXAS  
**ENTERED**  
MARSHALL, CLERK  
THE DATE OF ENTRY IS  
ON THE COURT'S DOCKET

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## Chapter 13

ADVERSARY NO. 03-4129

**v.**

Defendant.

## Page 1 of 12

provides for thirty-six monthly payments of \$131.06 (each a “Payment”).<sup>2</sup> If Plaintiff made each of the thirty-six Payments, he would acquire title to the Unit for no further consideration.<sup>3</sup> The Agreement’s initial term was one month, which term could be extended (up to thirty-five times) for an additional month by Plaintiff’s remittance of a Payment for the additional month. Plaintiff could terminate the Agreement at any time without penalty by voluntarily surrendering the Unit to Defendant.<sup>4</sup> Plaintiff agreed not to permit the Unit to be tied or otherwise affixed to any real estate in such a manner that it could not be removed without damage to the Unit.<sup>5</sup> If, during the term of the Agreement, the Unit was lost, stolen, damaged or destroyed, Plaintiff was responsible to Defendant for the “fair market value” of the Unit.<sup>6</sup>

There appears to be some ambiguity in the Agreement concerning termination and reinstatement. First, the Agreement states that if a termination occurs as a result of Plaintiff’s failure to make required payments, Plaintiff “shall have the right to reinstate the [A]greement . . . within five (5) days of the renewal date.”<sup>7</sup> In order to exercise this first reinstatement right, Plaintiff would have to pay all past due Payments as well as reasonable charges for pick-up, redelivery and refurbishment of the Unit.

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<sup>2</sup> Agreement at Page 1, ¶ 2(6). Each monthly payment was to be comprised of a rental payment of \$121.07 *plus* sales tax of \$9.99.

<sup>3</sup> Agreement at Page 1, ¶ 2(6). The Agreement further provides that Defendant shall retain title to the Unit until Plaintiff makes all thirty-six Payments. Agreement at Page 1, ¶ 2(7).

<sup>4</sup> Agreement at Page 2, ¶ 4.

<sup>5</sup> Agreement at Page 1, ¶ 3.

<sup>6</sup> Agreement at Page 1, ¶ 2(9).

<sup>7</sup> Agreement at Page 2, ¶ 5. The “renewal date” referenced in this section is not defined, but for present purposes the court assumes this refers to the date by which Plaintiff would otherwise have been required to tender a Payment to continue the Agreement for an additional one-month period.

In a subsequent provision, the Agreement deems Plaintiff's failure to make two consecutive Payments to be a voluntary surrender of the Unit.<sup>8</sup> After such a voluntary surrender of the Unit, Plaintiff was empowered, for *thirty* days thereafter, to reinstate the Agreement.<sup>9</sup> The Agreement is silent as to what steps Plaintiff was required to take to exercise this second right of reinstatement.

Pursuant to the Agreement and Plaintiff's instructions, Defendant delivered the Unit to Plaintiff at 7389 Highway 67E, Glen Rose, Texas. By the terms of the Agreement, the first Payment was due on February 1, 2003. Plaintiff failed to make the first Payment as required. On February 3, 2003 (the "Petition Date"), Plaintiff filed a case under chapter 13 of title 11 of the United States Code (the "Code"). The second Payment, which Plaintiff also failed to make as required, was due on March 1, 2003. On March 11, 2003, Defendant repossessed the Unit.

## **II. Procedural Background**

The commencement of a case under the Code automatically brings the stay of section 362(a) of the Code into play. Defendant contends it did not have notice of Plaintiff's chapter 13 case, and that, therefore, the apparent violation of the automatic stay resulting from Plaintiff's postpetition repossession of the Unit was unintentional. Having been unable to reach an accord with Plaintiff with respect to disposition of the Unit, Defendant filed its motion for relief from the automatic stay on March 24, 2003 (the "Motion"), and requested an expedited hearing thereon. On March 26, 2003, Defendant filed an amended motion for relief from the automatic stay (the "Amended Motion"). Also on March 26, 2003, Plaintiff filed his response to the Motion (the "Response") and a complaint (the "Complaint") instituting the above-captioned

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<sup>8</sup> Agreement at Page 2, ¶ 18.

<sup>9</sup> Agreement at Page 2, ¶ 6. If, at the time of the voluntary surrender, Plaintiff had paid 60% or more of the amount owed under the Agreement, the reinstatement period would be ninety days.

adversary proceeding. Plaintiff also filed a motion seeking expedited consideration of the Complaint. On March 27, 2003, this court held a preliminary hearing on the Motion, Amended Motion and Complaint. At the conclusion of the hearing, the court took this matter under advisement, instructed Defendant to return the Unit to Plaintiff and extended to the parties the opportunity to submit supplemental letter briefs and/or case citations to the court regarding the issue of whether the Agreement was a lease or security agreement.<sup>10</sup> On April 11, 2003, Defendant filed its answer to the Complaint (the “Answer”).

After the preliminary hearing, the parties entered into an agreed order (the “Agreed Order”), whereby Plaintiff agreed to make a Payment to Defendant on or before April 10, 2003, and further agreed to make each subsequent Payment on or before the 10th day of each month beginning in May 2003 until the earlier of the date on which : (a) Plaintiff’s case is dismissed or converted to a case under chapter 7; (b) the automatic stay is lifted pursuant to the terms of the Agreed Order;<sup>11</sup> or (c) the court issues its ruling on whether the Agreement is a lease or a security agreement.

### **III. The Parties’ Positions**

In the Motion and Amended Motion, Defendant takes the position that the Agreement was a true lease, which, by its own terms, was terminated prior to the Petition Date when Plaintiff failed to make the first required payment. If Defendant is correct, section 365 of the Code controls the issue.

Plaintiff, on the other hand, contends the Agreement embodied a secured transaction whereby Plaintiff agreed to purchase the Unit from Defendant. If Plaintiff is correct, section 365

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<sup>10</sup> Both parties accepted the court’s invitation and submitted supplemental authorities.

<sup>11</sup> On April 16, 2003, Defendant filed a notice of default citing Plaintiff’s failure to remit a Payment on or before April 10, 2003. The court understands that the parties were subsequently able to resolve that dispute, and Plaintiff retains possession of the Unit.

is not implicated, and the Agreement and the Unit will be treated as a security agreement and collateral, respectively.

#### **IV. Issues**

The issues before the court today are:

- 1) Whether the Agreement is a lease or a security agreement; and
- 2) Depending on the resolution of the foregoing issue,
  - a) If the Agreement is a lease, whether it is still “executory” such that Defendant can utilize section 365 to treat it in his chapter 13 bankruptcy case; or
  - b) If the Agreement is a security agreement, whether Defendant’s interest in the Unit is adequately protected.

#### **V. Discussion**

##### **A. Lease vs. Security Agreement**

State law controls the determination of whether an arrangement is a true lease or a security agreement. *See* *Butner v. United States*, 440 U.S. 48, 54-55, 59 L. Ed. 2d 136, 99 S. Ct. 914 (1979) (the existence, nature and extent of a security interest in property is governed by state law); *Morris v. Dealers Leasing, Inc. (In re Beckham)*, 275 B.R. 598, 600 (D. Kans. 2002). *See also In re Rigg*, 198 B.R. 681 (Bankr. N.D. Tex. 1996). *See also* 11 U.S.C. § 101, Historical and Statutory Notes (“whether a consignment or lease constitutes a security interest under the bankruptcy code will depend on whether it constitutes a security interest under applicable State or local law.”).

Under Texas law, the inquiry begins with Chapter 1 of the Texas Business and Commerce Code.<sup>12</sup> *See* TEX BUS. & COM. CODE §§ 1.201(37)(B) & (C). Section 1.201(37)(B)

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<sup>12</sup> Defendant has also cited the Texas Rental-Purchase Agreement Act in support of its position. *See* TEX BUS. & COM. CODE §§ 35.71 – 35.74. Section 35.71(6) of the Rental-Purchase Agreement Act defines a “rental-purchase agreement” as an agreement for the use of merchandise by a consumer for personal, family, or household purposes,

of the Texas Business and Commerce Code provides some guidance in determining whether a particular arrangement creates a lease or a security interest.<sup>13</sup> In relevant part, Section 1.201(37)(B) provides that the determination depends on the facts of the case, but that a transaction creates a security interest, as a matter of law, if: (i) the lessee's obligations are for the term of the lease and are not subject to termination; *and* (ii) one or more of the following is true: (a) the original term of the lease is equal to or greater than the remaining economic life of the goods; (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.<sup>14</sup>

According to Texas Business and Commerce Code Section 1.201(37)(C), a transaction does not create a security interest *merely* because it provides that: (i) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the

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for an initial period of four months or less that is automatically renewable with each payment after the initial period, and that permits the consumer to become the owner of the merchandise. The court is not certain this act sheds any light on the current controversy. Rather, TEX BUS. & COM. CODE §§ 1.201(37) appears to control the issue of whether the Agreement creates a lease or security interest, while the Rental-Purchase Agreement Act appears simply to provide additional consumer protections in transactions falling within its scope.

<sup>13</sup> For purposes of this memorandum opinion and order, the court will assume, without so holding, that the Unit is a "good" and that, therefore, this matter implicates the sections of the Texas Business and Commerce Code dealing with the sale or lease of goods. See TEX BUS. & COM. CODE § 2.105(a) ("Goods" means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . and things in action). Accord TEX BUS. & COM. CODE § 2.107(b) ("[a] contract for the sale apart from the land of . . . things attached to realty and capable of severance without material harm thereto . . . is a contract for the sale of goods within this chapter whether the subject matter is to be severed by the buyer or by the seller even though it forms part of the realty at the time of contracting, and the parties can by identification effect a present sale before severance.")

<sup>14</sup> TEX BUS. & COM. CODE §§ 1.201(37)(B). See also *In re Triplex Marine Maint., Inc.*, 258 B.R. 659, 669 (Bankr. E.D. Tex. 2000); *In re Kim*, 232 B.R. 324, 330 (Bankr. E.D. Pa. 1999).

goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into; (ii) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording or registration fees, or service or maintenance costs with respect to the goods; (iii) the lessee has an option to renew the lease or to become the owner of the goods; (iv) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or (v) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.<sup>15</sup>

In effect, Section 1.201(37)(B) relies on the trier of fact to determine whether an arrangement creates a security interest or a lease on a case-by-case basis. The exception to that general rule arises when the arrangement in question satisfies Section 1.201(37)(B)'s two-part test. In such a case, the implicated arrangement is deemed to create a security interest without further inquiry. The first prong looks to whether the putative lessee is obligated to fulfill his part of the bargain for the entire term of the lease. Here, the Agreement's stated term was thirty-six months. Plaintiff, however, was entitled to terminate the Agreement at any time without penalty during that thirty-six month term. Accordingly, the Agreement does not meet Section 1.201(37)(B)'s explicit requirements for an automatic determination that it is a security agreement.

The foregoing does not preclude, however, a determination by the court that, under the facts of the case, the Agreement is, in reality, a security agreement. To make that determination,

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<sup>15</sup> TEX BUS. & COM. CODE §§ 1.201(37)(C).

the court considers the provisions of the Agreement and the guidance provided by Texas Business and Commerce Code Sections 1.201(37)(B) & (C).

First, the Agreement itself is titled a “Rental Agreement”, and explicitly retains title to the Unit in the Defendant.<sup>16</sup> The Agreement also describes Plaintiff’s obligations as “rental payments”, and the parties as “lessor” and “lessee”.<sup>17</sup> Also of significance is the fact that Plaintiff had the right to terminate his obligations under the Agreement at any time without penalty by simply returning the Unit to Defendant.<sup>18</sup>

On the other hand, title to the Unit vests in the Plaintiff upon satisfaction of the Payment obligations, and a portion of each Payment is a sales tax. Moreover, the Agreement placed on Plaintiff responsibility to compensate Defendant for the then fair market value of the Unit in the event of loss, theft, damage or destruction.<sup>19</sup> The court notes, however, that, while Plaintiff bears the risk for the fair market value of the Unit, Defendant is potentially at risk to the extent its

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<sup>16</sup> *But see In re Triplex Marine, Maint., Inc.*, 258 B.R. 659, 666 (Bankr. E.D. Tex. 2000)(holding that, in determining whether a document is a true lease or a disguised security agreement, the court is not bound by any “acknowledgment” by the debtor nor by any other language or designation of parties contained in the agreement). *See also In re Homeplace Stores, Inc.*, 228 B.R. 88, 93 (Bankr. D.Del. 1998) (whether a document is a security agreement as opposed to a lease is dependent on certain factors extrinsic to the document and not capable of control by words in the document, *quoting* 2 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 565 (4th ed. 1995 & Supp. 1998).

<sup>17</sup> *But see In re Owen*, 221 B.R. 56, 62 (Bankr. N.D.N.Y. 1998)(finding that “the labeling of an agreement as a ‘lease’ and referring to the parties as ‘lessor’ and ‘lessee’ in and of themselves are not controlling”).

<sup>18</sup> *Accord In re Aguilar*, 101 B.R. 481, 483 (Bankr. W.D. Tex. 1989) (cognizable obligation on the part of lessee to complete payments under contract relevant to determination of whether contract created a lease or a security interest). *See also In re Peacock*, 6 B.R. 922, 924 (Bankr. N.D. Tex. 1980).

<sup>19</sup> *See In re Hydro Servs.*, 2000 Bankr. 1361, \*11 n.5 (Bankr. E.D. Tex. 2000) (considering which party bears the risk of loss or damage to be significant to the determination of whether a particular arrangement is a lease or security agreement). *See also In re Bergsoe Metal Corp.*, 910 F.2d 668, 671 (9th Cir. 1990) (considering indicia of ownership (i.e. risk of loss, responsibility to pay taxes, etc.) relevant to determination of whether an arrangement was a lease or security agreement).



obligations with respect to the Unit exceed that fair market value<sup>20</sup> (if, for example, Defendant had pledged the Unit to its lender, the amount due from Defendant upon destruction of the Unit might exceed the amount to be paid by Plaintiff). Further, in the event Plaintiff returned the Unit to Defendant before the expiration of the Agreement's thirty-six month term, Defendant would be forced to accept a loss to the extent the amount by which the Unit's depreciation exceeded the amount Defendant had received in Payments.

Based on the foregoing, the court concludes that, on balance, the facts in this case favor Defendant's position. The court therefore finds the Agreement was a true lease. As such, the court next looks to section 365 of the Code to determine the parties' relative rights with respect to the Agreement and the Unit.

#### **B. Plaintiff's Ability to Deal with the Agreement**

With limited exceptions, a debtor's estate is comprised of all legal or equitable interests in property as of the commencement of the bankruptcy case. *See* 11 U.S.C. §541(a). *See also* Safeway Managing Gen. Agency, Inc. v. Osherow (In re Davis), 253 F.3d 807, 810 (5th Cir. 2001). Section 541 is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir.), *cert. denied*, 469 U.S. 982, 83 L. Ed. 2d 321, 105 S. Ct. 386 (1984) (*quoting* H.R. Rep. No. 595, 95th Cong., 1st Sess., reprinted in 1978 U.S. Code Cong. & Ad. News 5787). Whatever rights a debtor has in property at the commencement of the case "continue in bankruptcy - no more, no less." *Id.* Included in a debtor's estate are contractual rights. *See* Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.), 824 F.2d 725, 730 (9th Cir. 1987) (contract rights become property of the estate when the case is

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<sup>20</sup> *Kemp Indus. v. Safety Light Corp.*, 857 F. Supp. 373, 388-89 (D.N.J. 1994) (whether lessee required to bear *entire* risk of loss, theft, damage and destruction relevant to determination of whether an arrangement is a lease or security agreement).

commenced). *Cf.* LATCL&F, Inc. v. Milbank (In re LATCL&F, Inc.), 2001 U.S. Dist. LEXIS 12478, \*10 (N.D. Tex. 2001) (property of the bankruptcy estate includes all rights of action the debtor may have arising from contract). *But see* Tonry v. Hebert (In re Tonry), 724 F.2d 467, 469 (5th Cir. 1984) (holding that *contracts* (as opposed to rights under a contract) do not become property of the estate until assumption, a distinctive immaterial in the case at bar).

Based on the foregoing, the court must interpret the Agreement to determine what rights became part of Plaintiff's estate. While there is some ambiguity as to which reinstatement provision controls in this matter (i.e. whether Plaintiff had five days or thirty days to reinstate), it is clear that the Agreement specifically grants to Plaintiff a right to reinstate upon the occurrence of specified events (which right accrued to Plaintiff's bankruptcy estate on the Petition Date). In a dispute regarding the meaning of an ambiguously drafted contract, one rule of construction is to interpret the terms of the contract against the drafter. *See* In re R & C Petroleum, Inc., 247 B.R. 203, 208 n.9 (Bankr. E.D.Tex. 2000). As Defendant apparently drafted the Agreement,<sup>21</sup> the court will construe any ambiguity in favor of Plaintiff. Accordingly, the court holds that the Agreement provided Plaintiff with thirty days to reinstate after a voluntary surrender of the Unit.<sup>22</sup> Further, that reinstatement right is property of Plaintiff's estate.

Having determined Plaintiff held a thirty-day right to reinstate the Agreement, the court must now consider when (or whether) that right accrued. The Agreement provides that Plaintiff's failure to make two consecutive Payments would amount to a voluntary surrender of the Unit. Plaintiff's first Payment was due on February 1, 2003. Plaintiff's second

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<sup>21</sup> At the March 27 hearing, counsel for Defendant represented that his client (with the assistance of other counsel) had drafted the Agreement.

<sup>22</sup> For the reasons stated below there is no need in this case to address the affect (if any) of section 108(b)(2) on the Agreement.

Payment was due on March 1, 2003. Plaintiff failed to make both Payments. Therefore, according to the Agreement, Plaintiff voluntarily surrendered<sup>23</sup> the Unit on or about March 1, 2003, and his right to reinstate the Agreement accordingly accrued upon the occurrence of that voluntary surrender.<sup>24</sup> By the court's calculation, the Agreement required Plaintiff to exercise that reinstatement right (if at all) by March 31, 2003.

As stated above, the Agreement does not specify what steps Plaintiff was required to take to exercise the thirty-day reinstatement right. On March 26, 2003, Plaintiff filed the Response and the Complaint, both in furtherance of his desire to regain possession of the Unit. At the March 27 preliminary hearing, Plaintiff expressed to Defendant and the court his desire to regain possession of the Unit and to continue the Agreement. Absent contrary direction from the Agreement, the court finds that Plaintiff's actions on March 26 and 27 properly perfected his right to reinstate the Agreement.

### **Conclusion**

The court having determined that the Agreement was in force as of the Petition Date, that Plaintiff had a right to reinstate the Agreement, and that Plaintiff properly exercised that right to reinstate the Agreement, it is hereby

ORDERED that, the Agreement having been determined to be an executory true lease, section 365 of the Code shall govern the relationship between Plaintiff and Defendant with respect to the Agreement; and it is further

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<sup>23</sup> While the court questions the "voluntary" nature of Defendant's surrender of the Unit (especially in light of the subsequent March 11, 2003 repossession), it will use the Agreement's language to describe the effect of Defendant's failure to make Payments in accordance with the Agreement.

<sup>24</sup> Further, and as a logical corollary to finding that Plaintiff's right to reinstate the Agreement did not accrue until March 1, 2003, the court further finds that the Agreement was in force until the time that right accrued. By necessary implication, the Agreement was therefore in force as of the Petition Date.

ORDERED that, as set forth in the Agreed Order, Plaintiff have and retain possession of the Unit so long as he complies with the terms of the Agreement; and it is further

ORDERED that the issue of sanctions against Defendant for its violation of the automatic stay shall be addressed if necessary upon further proceedings initiated by Plaintiff.

Signed this 8<sup>th</sup> day of May 2003.

A handwritten signature in black ink, appearing to read "D. Lynn", written over a horizontal line.

DENNIS MICHAEL LYNN  
UNITED STATES BANKRUPTCY JUDGE

Distribute: James Morrison  
Behrooz Vida  
Tim Truman, Ch. 13 Trustee